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Legal Notes

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RESPONSIBILITY IN LIMITED AUDITS

The recent decision of the supreme court of Alberta in *Jamieson, Austin & Mitchell, Ltd.* v. *Battrum* (1934), 1 Western Weekly Reports 324 affirms again the proposition of law that auditors are not liable for alleged negligence when the client by contract with them had so strictly limited the scope of their audit that it was practically impossible for them to uncover irregularities. The leading case of *International Laboratories, Inc.* v. *Dewar, et al.* (1933), 2 Western Weekly Reports 529, to this effect was discussed in The Journal of Accountancy for January, 1934.

In the Jamieson case the plaintiff was a small private company with only a few shareholders, most of whom were actually engaged in the management of its business as an insurance broker. The defendant was a professional auditor. The plaintiff sued the defendant, alleging that he was negligent in the performance of his duties as auditor and that the plaintiff thereby suffered damages. It appeared that the chief reason for defendant's employment was that defendant, who was not a licensed insurance agent, might through the medium of fees charged as auditor share to some extent in commissions received by plaintiff on insurance business produced by defendant. The defendant was not appointed by the shareholders or by the registrar, pursuant to the provisions of the companies act, but he was employed by the president on behalf of the company. The books of account were simple and if all entries had been properly made and all cash receipts properly deposited the financial condition of the company would have been disclosed by the cashbook and the general ledger. The president told the defendant that no auditing was needed but that defendant was to do some checking on the books. The defendant assisted the secretary-treasurer in balancing his books and during some of the years he prepared annual statements and signed them as auditor for the purpose of income-tax returns. He did a certain amount of detail checking, including the posting of totals to the general ledger, but during one of the years in question he did no checking in the clients' ledger which was a loose-leaf book. He checked cashbook entries with bank records but did not make an audit to ascertain whether or not all cash received had been entered in the cashbook. The directors knew that no audit was being made and they knew that their method of handling cash receipts, some of which were never entered in the cashbook or deposited in the bank, made defendant's work in checking of very little value. Defendant had no reason to suspect the slightest dishonesty on the part of any of plaintiff's officers.

In the action brought against defendant the main item of complaint was that a financial statement prepared by him overstated an account receivable by approximately $3,700. The court held that defendant was not responsible for this, because his statement correctly showed the financial condition disclosed by the general ledger and he had not been permitted to make any audit. Another claim was for an alleged shortage of $600 which defendant had not uncovered. The court held that this loss, if it was incurred, was caused directly by the negligent methods of plaintiff's officers and not by any act or omission of the defendant. The court held that it was not the defendant's duty to complain to the officers of the company, who were its main shareholders, concerning their methods of dealing with cash receipts. The plaintiff sought to charge him also with a failure to write off a sufficient amount of bad accounts receivable. The court cleared him of the charge of negligence in this respect, stating that "in this particular case at least, it would be preposterous for an auditor who knew nothing about the debtors to set up his judgment with respect to any particular accounts against the judgment of the officers of the company who knew the debtors personally and who must have had a more or less intimate knowledge of their general standing." The plaintiff was not allowed to recover fees paid to the defendant nor was it allowed to charge him with the cost of an investigation by other auditors after his discharge. The plaintiff's action was dismissed in its entirety.

AUDITOR'S DUTY UNDER ENGLISH COMPANIES ACT TO REPORT TO MEMBERS

An interesting and novel point was settled by the decision of the English high court (chancery division) on March 15, 1934, in the matter of *Allen, Craig & Co. (London), Ltd.* Section 134 of that statute directed that every auditor should make a report to the members of the company on the accounts examined by them. The court construed that section to mean that the report should be made to the members in a general meeting but, if none was called, the auditor's duty was fulfilled by sending his report to the secretary of the company. The official report of this decision is not yet available but it was summarized in *The Law Times* for March 31, 1934 (vol. 177, page 223), and in the law reports supplement to *The Accountant* for April 28, 1934.

Allen, Craig & Co., an importer of chemicals and oils, was registered in 1921 with a capital of £10,000. Its financial reports up to and including December 31, 1930, showed losses for every year, at an average of approximately £3,500. These reports were signed by two directors and by the auditors. The liquidator of the company sought to charge the auditors with misfeasance and to hold them, together with the managing director, for debts of the company contracted after a date in 1925. He did not allege any deliberate misconduct by the auditors or any lack of professional skill on their part, but based his claim on the fact that the auditors rendered their report to the company secretary who did not call a meeting of the members. The liquidator argued that when no general meeting was called the auditors should send a copy of their report to every member of the company. The court held that this was not required by the statute. The auditors had no power to call a meeting of members or to compel any company officer to call one, and the meaning of the statute could not be alternative and depend on whether or not a general meeting was called. To require the auditors to send a copy of their report to every member would impose an undue burden on the auditors. The statute was construed to mean that the report should be presented to the members at a general meeting if one was called; if none was called, the report should be sent to the secretary who could be compelled by the members to disclose it.

The managing director, who was characterized as an incurable optimist, was held liable for the debts, but the charges against the auditors were dismissed.

The auditors had written several long letters to the company analyzing its financial condition and drawing attention to the necessity of having a general meeting of shareholders unless further capital was procured, but the managing director had done nothing except to discuss these letters with the auditors who wrote them.

AUDITOR AS EXPERT WITNESS

In the Canadian litigation between the trustee in bankruptcy of the Blue Band Navigation Company and Price Waterhouse & Co., one of the incidental points is of interest to accountants in the United States who from time to time serve as trustees in bankruptcy or in other similar capacities. The court held that a trustee in bankruptcy can not be compelled to give evidence as an expert simply because he happens to be a member of a certain calling of which one of the parties to the litigation is a member. *Trustee of the property of Blue Band Navigation Company, Ltd., a bankrupt,* v. *Price Waterhouse & Co.,* 47 British Columbia Reports 258.

The Blue Band company had been engaged in the towing business from its incorporation in 1920 to its bankruptcy in 1931. The defendants had been its auditors since the date of incorporation. The trustee in bankruptcy sued the auditors for alleged negligence, misfeasance and breach of contract. During an examination of the trustee, who was an auditor by profession, he was asked this question: "When you conduct an audit yourself, Mr. Carmichael, do you find it necessary to rely to some extent upon the statements made to you by officers of the company on information supplied to you by them?" He refused to answer the question and both the lower court and the court on appeal sustained him in his refusal. One of the judges stated that it would be unfair to the bankrupt company to hold it bound by any opinion which the trustee might express as a member of any calling or profession to which he might belong. He should be examined only as to matters directly concerning the company he represents. One of the other judges indicated that it might be proper to examine the trustee as an expert because he, as an auditor, had advised himself, as trustee, that a cause of action existed against the defendants and he should be subject to cross-examination as to the facts and practices upon which he based his opinion.

On the point of the auditor's right to rely on information and statements made by officers of the company, the chief justice wrote that clearly he could not rely upon statements to the effect that there was nothing wrong with the books, but that he was entitled to get such information as would enable him to examine the books with intelligence.